Supreme Court, U. S.
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IN THE
SUPREME COURT OF THE UNITED STATES
Fall Term, 1978

No. 77-1410

IN THE MATTER OF:
Golden Enterprises, Inc., Bankrupt

William E. Butner, Petitioner,

vs.

Joe N. Cagle, Trustee in Bankruptcy for Golden Enterprises, Inc.; Attorneys for the Creditors' Committee; James M. Gaither, Jr., Attorney for Bankrupt; Golden Enterprises, Inc., Bankrupt; William J. Lawing, CPA for Bankrupt; and Charles B. Camp, Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit
Petition for Certiorari Filed April 4, 1978
Certiorari Granted June 12, 1978

BRIEF FOR THE RESPONDENTS

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BRIEF FOR THE RESPONDENTS

OPINIONS BELOW

The opinions of the Bankruptcy Court (App. to Pet. for Cert. pp. 2a-20a) and the District Court (App. to Pet. for Cert. pp. 21a-30a) are unreported. The opinion of the Court of Appeals (App. to Pet. for Cert. pp. 31a-43a) is reported at 566 F. 2d 1207.

JURISDICTION

The judgment of the Court of Appeals was entered on December 8, 1977 (App. to Pet. for Cert. pp. 31a-43a) and a petition for rehearing was denied on January 6, 1978 (App. to Pet. for Cert. p. 44a). The petition for Writ of Certiorari was filed on April 4, 1978, and granted on June 12, 1978.

QUESTION PRESENTED

Whether under federal bankruptcy, the second mortgagee of real property is entitled to rents accruing during the period from the initiation of liquidation proceedings to the Trustee's sale of such real property, where the second mortgagee does not have a lien on the rents under North Carolina law, the second mortgagee does not seek to foreclose his mortgage, the second mortgagee does not seek to have the rents sequestered for his benefit, and the second mortgagee has no equitable basis for his claim, either during the arrangement phase or liquidation phase of proceedings under the U.S. Bankruptcy Act.

STATEMENT

Golden Enterprises, Inc. ("Golden") was incorporated under the laws of the State of North Carolina in 1968. On May 4, 1973, Golden filed a Petition in Bankruptcy for an Arrangement under Chapter XI of the Bankruptcy Act, 11 U.S.C. Section 701, et. seq.. The Bankruptcy Docket of Golden reflects that it was very active during the arrangement period, involving many unique and complex Adversary Proceedings, negotiations, Court Hearings, sales, refinancing of loans, completion of buildings, and many other matters as the record reflects. During the arrangement period, the secured parties cooperated fully with the Creditors Committee and Golden. In fact, everyone cooperated fully during this period in Golden's effort to pay its creditors.

A Plan of Arrangement was approved by the Creditors Committee and the Court and was accepted by a majority in kind and amount of the unsecured creditors. The plan called for sums to be paid to creditors from the sale of merchandise from debtor's stores initially with the balance to be paid from excess rental income derived from extensive real estate owned by debtor in Catawba County, North Carolina. The several parcels of real estate were subject to various first Deeds of Trust to different lending institutions and a second Deed of Trust

to William E. Butner (Petitioner) and Robert L. McKaughn, Jr. for $250,000,evidencing their joint loan to Golden.

Because of the severe economic recession existing in early 1974, the Plan of Arrangement was amended on April 17, 1974, to provide for completion of a 46,000 sq. ft. warehouse building and to join in interest the Petitioner, McKaughn, and Jack Sipe Construction Company. The transaction was evidenced by a $360,000 Deed of Trust on Golden's real estate which was subject to the first Deeds of Trust. This new Deed of Trust was dated July 1, 1974, and recorded July 22, 1974, in the office of the Register of Deeds, Catawba County, in Book 1051 at page 184. This Deed of Trust and the Note secured thereby was subject to the following conditions imposed by the Bankruptcy Court:

a. It was to bear interest at the rate of 10% per annum.

b. The holders of the Deed of Trust were not to foreclose except upon notice to all parties and with the permission of the Bankruptcy Court. (App. p. 195a)

This Deed of Trust did not provide for any security interest in, or an assignment of, the rents in event of default. Also, there was no separate Assignment of Rents executed or recorded in this transaction.

Prior to the transactions discussed in the foregoing paragraph, an agent had been appointed upon motion filed by Golden on April 18, 1974, to collect rental income and to pay Federal and State income taxes, first mortgage holders, ad valorem tax authorities, insurance premiums, and second mortgage holders (App. p. 204a). The Motion noted that an agent was needed because no assets of debtor remained except real estate and there were no employees available to perform the services requested therein (App. p. 202a). The agent collected rents and made payments pursuant to the Order until adjudication of bankruptcy on February 14, 1975. The agent paid Petitioner, et al., according to the terms of the Deed of Trust through November 1974 (App. p. 271a, 279a).

Between April 1974 and the date of adjudication, Golden experienced continuing difficulties with cash flow due to the loss of certain tenants. Petitioner received no interest payments beyond the month of November 1974.

However, the Plan of Arrangement was not successful and Golden was adjudged a Bankrupt on February 14, 1975, and the proceeding was converted into a liquidating bankruptcy. Joe N. Cagle was appointed the Trustee and the first meeting of creditors was held on April 16, 1975. At the initial meeting of creditors, Petitioner requested

that the real estate be abandoned to him, subject to the first mortgages. While not directly opposing the abandonment, the Trustee suggested a foreclosure sale of the real estate.

During the ensuing liquidating bankruptcy, the Trustee collected the rents but by instruction of the bankruptcy court made no payments to Petitioner. Petitioner took no steps to appeal these instructions.

In 1975, the assets of the Bankrupt consisted primarily of six (6) tracts of real estate. Most of the buildings on the various parcels were already rented at the time that Golden was adjudged a Bankrupt. Thereafter, pursuant to Bankruptcy Court approval, the Trustee rented certain portions of the other parcels of real estate.

Two (2) of the tracts consisted of vacant land which was subject to an outstanding first Deed of Trust in favor of First Citizens Bank & Trust Company. On May 27, 1975, First Citizens Bank & Trust Company filed an Adversary Proceeding as required by Bankruptcy Rule 701 in the Bankruptcy Court seeking to recover the two parcels of land subject to its lien from this Bankruptcy Proceeding so that it could pursue the available foreclosure remedies under the laws of the State of North Carolina. By Order of June 4, 1975, the Bankruptcy Judge released the two parcels of land from this Bankruptcy Proceeding to First Citizens Bank & Trust Company.

The remaining four (4) tracts of land were encumbered with four separate first mortgages from different lending institutions. All four tracts were encumbered with the one "blanket" second mortgage which was effected during the arrangement period. This second mortgage was for the total sum of $360,000.00, which arose from the balance owed on a construction contract to Jack Sipe Construction Company ("Sipe") in the sum of $110,000.00 and joint loan of $250,000.00 from Robert L. McKaughn, Jr. ("McKaughn") and William E. Butner ("Butner"). It should be noted again that the second mortgage did not provide for any security interest in, or an assignment of, the rents in event of default. Certain tax liens were also outstanding.

On or about June 11, 1975, the Trustee filed an Adversary Proceeding in the Bankruptcy Court pursuant to Part VII of the Bankruptcy Rules (App. p. 421a) seeking to sell the four tracts of real estate subject to the first mortgages but free and clear of the second mortgage and other liens. The secured parties were joined as party Defendants. Butner (as well as Sipe and McKaughn) cooperated fully in that proceeding and, in fact, Butner filed no Answer. The other secured parties filed Answers and consented to the sale being made in that manner. The hearing was held, after notice,

and the Bankruptcy Judge entered the Order for Sale on June 30, 1975. No creditor appeared at the Hearing to object to this Order. The Order authorized and directed the Trustee to sell the real estate subject to the first mortgages but free of the second liens, with their liens transferred from the real estate to the proceeds of the sale.

No appeal was taken from the Order of June 30, 1975, and it became final ten days thereafter under Bankruptcy Rule 803. The Trustee held the public sale on July 28, 1975, after much advertisement and notice to creditors, in accordance with the Bankruptcy Rules and the Order of the Court.

The tracts were sold separately. The Bankruptcy Judge confirmed the sale of two tracts and did not confirm the sale of the remaining two tracts. From the Confirmation Order entered August 11, 1975, Butner appealed to the United States District Court.

On November 7, 1975, the District Court ordered that a resale be made subject to the first mortgages and taxes with the lien of all subsequent lienholders (including the second mortgage) transferred and attached to the proceeds of the sale, said resale to be held on November 12, 1975. By the terms of the aforesaid Order of the District

Court, Butner and McKaughn and Sipe were permitted to bid at the resale the amount of their second mortgage in lieu of a cash bid. Butner had acquired the interests of McKaughn and Sipe in the second mortgage prior to the resale. At the resale, Butner became the highest bidder at the price of $174,000.00.

Butner received a Deed to the real estate from the Trustee on or about November 25, 1975, which Deed specifically reserved the rents derived from the real estate to the Trustee (App. p. 658a).

The balance of Butner's second mortgage claim in the sum of $186,000.00 was allowed as an unsecured claim by the Bankruptcy Court at the final meeting of creditors.

After acquiring title to the property, Butner filed a Motion for distribution of funds on December 1, 1975, and requested that the rental income held by the Trustee be distributed to him. The Motion was heard at the final meeting of creditors on June 4, 1976, and was denied.

Butner appealed the order of the Bankruptcy Judge to the United States District Court for the Western District of North Carolina, where the Honorable Woodrow W. Jones, Chief Judge, reversed and vacated the

Bankruptcy Judge's denial of Butner's claim upon the rents derived from the encumbered real estate as additional security for his indebtedness. (App. to Pet. for Cert., pp. 21a-30a) From the order of the District Court, the United States and the Trustee, et al., appealed to the United States Court of Appeals for the Fourth Circuit where the United States' appeal on its tax claim was consolidated with the appeal of the Trustee, et al., for briefing and argument. The appeal was heard on October 4, 1977, and on December 8, 1977, the Fourth Circuit Court of Appeals, Senior Circuit Judge Bryan dissenting, reversed the judgment of the District Court and remanded the case for compliance with the final order of the Bankruptcy Court. (App. to Pet. for Cert. pp. 31a-42a) Butner's petition for a rehearing was denied by the Court of Appeals on January 6,1978, (App. to Pet. for Cert. p. 43a) and his motion for a stay of mandate pending petition for writ of certiorari to the United States Supreme Court was denied on January 16, 1978. (App. to Pet. for Cert. p. 44a) Butner petitioned the United States Supreme Court for a writ of certiorari on March 28, 1978, and certiorari was granted on June 12, 1978.

SUMMARY OF ARGUMENT

Upon adjudication, a Trustee in bankruptcy takes title to all of a bankrupt's real property subject to all valid liens thereon. The nature and extent of those liens are determined by reference to the state law of the situs of the property.

In this case, Butner had a second mortgage on the bankrupt's real estate. He did not have a lien upon rental income derived from the property under state law or by contract. In North Carolina the mortgagor in possession, even after default, is entitled to the rents from mortgaged property until the property is foreclosed. Nor did Butner take steps during the arrangement proceeding or subsequent liquidating bankruptcy to create or perfect a security interest in rents.

An agent was appointed during the arrangement proceeding to collect the rents and pay certain

debts, including that of Butner. The order was not the result of any adversary hearing, however, and decided no substantive rights in respect to the rents.

After taking title, the Trustee had no notice of Butner's claim to rents until after the real property was sold by the Trustee and purchased by Butner. Butner's Proof of Claim made no claim for the rents, nor did Butner claim the rents during the Adversary Proceeding instituted by the Trustee under Part VII of the Bankruptcy Rules to sell the real property free of Butner's lien.

The Trustee sold the real estate free of the second mortgage with the lien of the second mortgage transferred to the proceeds of the sale. After the sale, the lien of the second mortgage on the real estate was extinguished; it was transferred to the proceeds of the sale.

The Trustee's sale served to place a value on the second mortgagee's only security for his debt.

In addition, Butner accepted the Trustee's Deed reserving the rents to the Trustee. Not until after Butner gained possession of the property did he claim the rents in the hands of the Trustee.

Moreover, since Butner was the purchaser of the real property, his debt was discharged and his second mortgage lien was extinguished under the North Carolina doctrine of merger.

Furthermore, it appears from the record that Butner was made whole.

In summary, Butner performed no acts during the arrangement or subsequent liquidating bankruptcy to establish a right to rents superior to the claim of the Trustee.

ARGUMENT

I

The case presents for review a contest between a Trustee in bankruptcy for the general estate and a mortgagee of bankrupt's real property over rental income collected by the Trustee between adjudication and the sale of the property by the Trustee.

It arose from the Bankruptcy Court for the Western District of North Carolina. In overruling the Bankruptcy Judge, the District Court held that the mortgagee became entitled to a lien upon the rents valid against the Trustee by reason of the appointment of an agent to collect rents and pay debts during a time when the bankrupt was a debtor in possession under Chapter XI of the Act. (App. to Pet. for Cert. p. 27a.)

The Circuit Court reversed, holding that Butner did not take steps during the arrangement proceeding or the period following adjudication

sufficient to perfect a lien upon the rental income, absent bankruptcy, according to North Carolina law. Such failure to perfect according to state law caused the Court to deny his claim as against the Trustee in the bankruptcy proceeding (App. to Pet. for Cert. p. 35a-37a).

A. The North Carolina Law

It is well settled that a Trustee in bankruptcy becomes vested with title to bankrupt's property subject to all valid liens and encumbrances. See Section 70 (a) of the Bankruptcy Act (11 U.S.C. § 110(a)).

The nature and extent of those liens and encumbrances are determined by reference to the state law of the situs of the property. Such reference to state law is not only appropriate, but required. See Stellwagen vs. Clum, 245 U.S. 605, 613; Thompson vs. Magnolia Co., 309 U.S. 478, 483-484.

This is eminently proper in light of the doctrine enunciated in Erie Railroad Co. vs. Thompkins, 304 U.S. 64.

Absent bankruptcy, Butner did not have a lien on rental income under North Carolina law. The Deed of Trust instrument under which he claims did not contain an assignment of rents upon default as additional security for his indebtedness (App. p. 445a). Further, the mortgagor in possession is entitled to the rents and profits which the mortgaged premises produce in the absence of a stipulation to the contrary. Even after default, the mortgagor is entitled to the rents and profits of the mortgaged premises prior to the time the mortgagee takes possession by foreclosure. Webster, Real Estate Law in North Carolina §236 (1971); Gregg vs. Williamson, 246 N.C. 356, 98 S.E. 2d 481 (1957); Kistler vs. Development Co., 205 N.C. 755, 172 S.E. 413 (1934); and Parker Co. vs. Bank, 204 N.C. 432, 168 S.E. 681 (1933).

adequate remedy at law. See In re Penny, 10 F. Supp. 638 (M.D.N.C. 1935); Scoggins vs. Cooch, 211 N.C. 677, 191 S.E. 750 (1937); Murphy vs. Murphy, 261 N.C. 95, 134 S.E. 2d 148 (1964).

B. The Split Among the Circuits

In accord with the decision below, the First, Second, Fifth, Sixth, Eighth and Ninth Circuits have ruled that the mortgagee's right to assert his interest in rents and profits is determined with reference to what would have been necessary under state law had there been no bankruptcy. Generally this is taken to mean that the mortgagee must take the same steps, by leave of or through the Bankruptcy Court as would have been necessary to create his lien at state law. See Petition of Cox, 15 F. 2d 764, 765 (1st Cir. 1926); In re Humeston, 83 F. 2d 187, 188 (2nd Cir. 1936); In re Brose, 254 F. 664, 666 (2d Cir. 1918); Merchants' and Mechanics' Bank vs. Sewell, 61 F. 2d 814, 817 (5th Cir. 1932); In re Thomas, 36 F. 2d 221, 222 (5th Cir. 1929); In re American Fuel and Power Co., 151 F. 2d 470, 481

Butner then was not entitled, under state law, to the rents and profits issuing from the collateral until he instituted foreclosure proceedings pursuant to the power of sale contained in his Deed of Trust (N.C. Gen. Stat. §45-4 et. seq.) and gained possession. This procedure involves an adversary proceeding before the Clerk of Superior Court in the County where the property is located. Naturally, a default must be alleged and proved (N.C. Gen. Stat. §45-21.16(d)).

He was also not entitled to have a receiver appointed except as an ancillary remedy to judicial foreclosure (N.C. Gen. Stat. §1-339.1 et. seq.) or foreclosure by power of sale where "before judgment, on the application of either party, when he establishes an apparent right to property which is the subject of the action and in the possession of an adverse party, and the profits are in danger of being lost, or materially injured or impaired" (N.C. Gen. Stat. § 1-502(1)). In such situations, the appointment is an extraordinary remedy and will not be granted except upon a showing that the applicant does not have an

(6th Cir. 1945); Tower Grove Bank and Trust Co. vs. Weinstein, 119 F. 2d 120, 122 (8th Cir. 1941); In re Hotel St. James Co., 65 F. 2d 82 (9th Cir. 1933).

The contrary line of authority is in the Third and Seventh Circuits. See In re Pittsburgh-Duquesne Development Co., 482 F. 2d 243 (3rd Cir. 1973); In re Wakey, 50 F. 2d 869 (7th Cir. 1921). Those courts have held that the mortgagee may recover the rents if he can establish an equitable basis for his claim. The rationale for these decisions is that the rights of the creditors are fixed at the adjudication of bankruptcy and the bankruptcy divests the mortgagor's possession of the realty. Therefore, the rents arising thereafter belong to the mortgagee and should not be diverted to general creditors. See 4A Collier on Bankruptcy §70.16 (14th ed. 1976). Under these decisions, however, the mortgagee cannot recover the rents arising during bankruptcy unless he establishes that "the mortgage property was worth less than the mortgage indebtedness." In re Cigar Stores Realty Holdings, 69 F. 2d 823, 824 (2nd Cir. 1934). In those circumstances, the Third and Seventh Circuits regard the rents as belonging to the

mortgagee as a matter of equity as part of the agreed security "to vindicate its own right of property." In re Pittsburgh-Duquesne Development Co., supra, 482 F. 2d at 246.

C. Butner's Acts During The Arrangement Proceeding

Butner apparently concedes that he had no security interest in the rents at state law prior to the petition for arrangement. He nevertheless contends that the intervention bankruptcy entitles him to a lien by operation law in accord with the rule of the Third and Seventh Circuits. He also contends that he performed acts during bankruptcy to establish his lien.

In regard to the latter, he advances the argument that the first and second mortgage holders obtained the appointment of an agent to collect the rental income from debtor's real estate and, that having secured the appointment of a receiver, he was not required to perform additional acts to establish his claim (Pet. Brief p. 44-45). This contention misrepresents the facts

and ignores the record of this case.

In the first place, the motion for appointment of the agent was not filed by Butner. The debtor moved the Court for the appointment of an agent at the request of secured creditors (including Butner) and the unsecured creditors (Creditors Committee) "...with directions to collect the rents, make all mortgage payments, pay taxes, insurance, and repairs and accumulate excess cash flow for the benefit of the secondary lienholders and the unsecured creditors." (App. p. 202a-203a)

The motion and resulting order (App. p. 204a-206a) in no way attempted to create or perfect a security interest in any creditor in respect to the rental income. By its very terms it only provided a means for paying the obligations of debtor contemplated by its amended plan of arrangement for unsecured creditors since it had but one employee (App. p. 202a).

Even if the agent were a receiver within the meaning and scope of Rule 201 of the Bankruptcy Rules of Procedure as the District Court ruled, the appointment in and of itself does not create or perfect a lien on rents valid against the Trustee. The receiver under Rule 201(g) is a "mere custodian unless, upon proper cause shown, his duties are enlarged or otherwise specified by order of court" (Rule 201(g)). A reading of the motion and order relied upon by Butner clearly shows the absence of any finding that Butner had a substantive right to the rental income of the debtor in possession. Indeed, Butner's debt was paid according to its terms during the arrangement until just prior to adjudication and qualification of the Trustee. [See the agent's reports to the court showing payment to Butner or McKaughn monthly amounts of interest due according to the terms of the Deed of Trust (App. p. 251A, 258a, 260a, 263a, 279a,) through November, 1974. Adjudication occurred February, 1975.]

Since Butner was not even entitled to foreclose until default occurred, due process would seem to at least require notice of default to either the court or the agent as a prerequisite to the creation of a lien upon rents since the mortgagee had no lien by contract or operation of law prior to the default. See Mortgage Loan Co. vs. Livingston, 45 F. 2d 28 (8th Cir. 1930).

In summary, Butner did not, by virtue of the appointment of the agent, ipso facto obtain a perfected lien upon rents during the arrangement proceeding. The appointment order decided no substantive rights among creditors with regard to the income; indeed, the order was not the result of any adversary proceeding involving any creditor's substantive right to rents by reason of a perfected lien. It was, rather, a vehicle to make payments to creditors pursuant to its accepted but not yet confirmed plan of arrangement, nothing more, nothing less.

D. Butner's Acts Following Adjudication

The debtor was adjudicated a bankrupt Feb. 14, 1975, 21 months after filing its petition for an arrangement (App. p. 337a) and the Trustee was appointed (App. p. 339a). He became vested with title to all debtor's (now bankrupt's) property pursuant to Section 70 of the Bankruptcy Act (11 U.S.C. §110) subject to all valid liens thereon. The Trustee began collecting the bankrupt's property including rental income for liquidation according to the terms of the Act. See Section 47 of the Act (11 U.S.C. §74) and Rule 605(a) of the Rules of Bankruptcy Procedure.

Butner filed a proof of claim with the court (App. p. 442a). Conspicuously absent from the claim, however, was any claim of lien upon rental income. Rule 302(c) of the Rules of Bankruptcy Procedure requires that "...if a security interest in property of the bankrupt is claimed, the proof of claim shall be accompanied by satisfactory evidence that the security interest has been perfected." An examination of Butner's claim shows he only claimed a security

interest in the real estate described in the Deed of Trust attached as an exhibit to his claim (App. p. 445a).

When, then, did Butner give the Trustee notice that he claimed a lien upon rental income? Examination of the record reveals no notice to the Trustee regarding Butner's or any other creditor's claim upon rental income during the time the Trustee had possesion of the property. As previously mentioned, Butner's proof of claim filed July 1, 1975 (App. p. 442a) made no claim for rents as security for the claim. This was so even though the Trustee had been collecting rents since February, 1975.

In fact, Butner had been made a party to the Trustee's Adversary Proceeding to sell the bankrupt's property free of liens except first Deeds of Trust (App. p. 421a) and yet filed no responsive pleading. This occurred in June, 1975 (App. p. 438a-441a).

The sale was held July 28, 1975 and confirmed by the Bankruptcy Judge on August 4, 1975 (App. p.

562a-571a). Though he had filed no answer on the Adversary Proceeding to sell, he did file a Motion for Amendment and Alteration of Judgment (App. p. 612a-640a) which was denied (App. p. 641a) and he appealed the confirmation order to the District Court (App. p. 604a). Throughout this proceeding and subsequent appeal Butner could have raised his claim upon rents. Yet, he did not. He could have taken steps in the Adversary Proceeding and appeal parallel with state law remedies to protect any claim he may have had upon the rental income. Yet, he did not.

The property was ultimately sold in November, 1975 and Butner was the high bidder at the sale. The Deed to Butner reserved accrued rents to the Trustee (App. p. 672a), but Butner accepted and recorded it.

Thus, Butner elected to wait until he got possession of the property to become entitled to the rents. This is in accord with North Carolina law. See Gregg vs. Williamson, 246 N.C. 356, 98

S.E. 2d 481; Kistler vs. Development Co., 205 N.C. 755, 172 S.E. 2d 413. He belatedly filed a Motion for Distribution of Funds (App. p. 689a), but this was after he got possession of the property.

It should be noted that throughout the period following adjudication until the sale (February, 1975 to November 1975) Butner had other remedies available to him to perfect a lien upon rents. He could have obtained relief from the stay against enforcement of liens imposed by Rule 401 of the Bankruptcy Rules of Procedure by filing a complaint pursuant to Part VII of the Bankruptcy Rules of Procedure. This remedy was available just as Rule 11-44 had been under the arrangement proceeding. The obtaining of consent to pursue his lien on the collateral would have gained him possession much sooner than he got it.

He could have also filed a complaint pursuant to Rule 701 of the Bankruptcy Rules of Proceeding to "recover money or property" or "to determine the validity, priority, or extent of a lien or other interest in property." See Rule 701(1), (2). Had

he done so no one could complain for the doing would have qualified as a substitute for possession in accord with the decision below.

Therefore, Butner did not following adjudication take any steps or perform any acts that would qualify him as a lien claimant upon the rents. In fact, his actions affirmatively showed his willingness to await possession to begin collecting the rents.

II.

The power of Bankruptcy Courts to sell the Bankrupt's assets extends also to encumbered property. In the absence of any reference to the contrary in the order of sale, a Bankruptcy Sale is made subject to valid liens and other encumbrances, in which case the interests of lienholders are in no way affected by the sale. But it may often be impracticable to sell the property subject to liens. Pending or prospective litigation over the validity of liens may be such that any sale on that basis could not be consummated. The presence of encumbrances attached to the property may in any event make a sale subject to liens unattractive to prospective purchasers--as, for example, where the interest rate on the encumbrances is in excess of prevailing interest rates at the time of sale. The presence of one

second Deed of Trust covering several tracts, which have separate first liens thereon, may also make a sale unattractive to prospective purchasers. These and many other reasons may indicate that the interests of the Bankrupt's creditors will be better served by a sale of the Bankrupt's property free of one or more liens and encumbrances. The Court does not require consent on the part of the lienholder and may sell the property despite his objection thereto. But if such consent is expressly or impliedly given, it may result in rendering the lienholder or mortgagee liable for a larger share in the administrative expenses than he would have been called upon to bear if the Court had proceeded against his will. See 4A Collier On Bankruptcy ¶70.97[2], pp. 1131-1142.

A. Reliance Upon The Bankruptcy Court Order of 30 June 1975 And The District Court Order of 7 November 1975

The Order of the Bankruptcy Judge of June 30, 1975, authorized and directed the Trustee to sell the real estate subject to the first mortgages but free and clear of the second mortgage with the lien of the second mortgage transferred from the property to the proceeds of the sale (App. p.438a). No appeal was taken from this Order and it became final. After the sale, the Confirmation Order was appealed by Butner to the District Court (App. p.604a). The Order of the District Court of November 7, 1975, authorized and directed the Trustee to sell the real estate subject to the first mortgages but free and clear of the second mortgage with the lien of the second mortgage transferred from the property to the proceeds of the sale. (App. p.653a).

The only difference in the District Court Order directing the Trustee to resell the real estate was that the second mortgage holders were authorized to use the amount of their debt to bid on the property in lieu of a cash bid. In other words, no one appealed the Orders of the Bankruptcy Court and the District Court wherein the Trustee was authorized and directed to sell the property free and clear of the second mortgage with the lien of the second mortgage transferred to the proceeds of the sale. All parties relied upon the plain meaning of the said Orders and acted accordingly. If there had been any question about whether the lien of the second mortgage was transferred from the real estate to the proceeds of the sale, then an appeal would have been taken from said Orders. The fact of the matter is that all parties believed the Orders to mean just what they plainly stated.

B. The Actual Sale

Pursuant to an Adversary Proceeding, the collateral was sold free and clear of the second mortgage lien with the lien transferred from the property to the proceeds of the sale. The District Court allowed the second mortgage holders to bid at the sale with the amount of their debt in lieu of a cash bid. Butner became the highest bidder at the resale of the collateral in the amount of $174,000.00. If the said mortgage holder had actually paid that amount of the bid, this money would have been distributed to second mortgage holders, less the Trustee's commissions. Thus, none of the funds in the hands of the Trustee were derived from the sale of the collateral and the balance of this claim was disallowed as a secured claim by the Bankruptcy Judge.

Admittedly, prior to the sale, Butner was a secured creditor. After the sale, he no longer had a security interest because it was "transferred to the proceeds of the sale." This kind of bankruptcy procedure, i.e., a sale free of liens with the liens transferred to the proceeds, either means what it says or the Bankruptcy Courts need to be otherwise informed because the procedure is quite common across the country. It is submitted that this procedure is valid. After the sale, Butner's mortgage was effectively cancelled, else, he could not have resold the properties and refinanced them as he subsequently did. Since Butner's mortgage was cancelled by law, he no longer had a lien on the real estate.

C. The Trustee's Deed

At the resale of the real estate, the Trustee sold the real estate but did not sell, convey or transfer the collected rents. The Trustee's Deed dated November 19, 1975, to Butner, contained the following reservation:

> "The accrued rents and the right to collect unpaid accrued rents from the above-described tracts of real estate are hereby expressly not conveyed, but are reserved to the Grantor. (App. p.658a).

D. Equity

A reading of the Order of the Bankruptcy Court dated July 1, 1976, reflects that the Bankruptcy Judge was aware of the equities in this matter. (App. p. 770a). No Appellate Court has yet found any of the Bankruptcy Judge's findings to be "clearly erroneous " under

Bankruptcy Rule 810. Thus, the Appellate Courts are bound by the findings made by the Bankruptcy Judge. In this case, there are no special equities in favor of Butner's claim. While the District Court stated that it found "no difficulty in determining that equity requires that rents collected" belonged to Butner, the Court of Appeals properly observed that "the District Court failed to articulate the equitable considerations that it thought required the result that it reached." (App. p. 802a). The record also indicates that the property was worth more than the bid-in price indicated and that Butner was not only made whole from his purchase of the Bankrupt's real estate, but he apparently profited from the ultimate disposition of the property. See Affidavit And Supplemental Report To The Court, App. p. 775a. It would not be equitable to now give him a windfall of the rents. In these

circumstances, the Court of Appeals correctly concluded (App. p. 802a) that even "[i]f equity has a part in the resolution of a question of this type . . . equity does not supply the answer here."

Further, it would be strange indeed for "equity" to create a lien where none existed and that is the result should this Court rule that Butner is entitled to the rents. To so hold would destroy the generally accepted principles of real estate law in North Carolina.

III.

A. Valuation Of The Second Mortgage By The Bankruptcy Court

Section 57h of the Bankruptcy Act and Bankruptcy Rule 306(d) deal with the fixing of the value of the security of the secured party's claim. The Bankruptcy Court may utilize one of several methods for this valuation. The first is by converting the security into money by a public sale.

Another way is by agreement, arbitration, compromise, or liquidation, as the Court may direct. The public sale indicated the value of the security of the second mortgage holders. The sale showed to the Bankruptcy Court that the second mortgage security was only worth $174,000.00 under Section 57h of the Bankruptcy Act and Bankruptcy Rule 306(d). Therefore, since the lien was transferred to the proceeds of the sale (in the sum of $174,000.00), it (the security) was fully satisfied by the sale. The balance of Butner's claim was allowed as unsecured by the Bankruptcy Court (App. p. 770a).

B. The Debt Represented By The Second Mortgage Was Extinguished Under the North Carolina Doctrine of Merger

It is the general rule (and the law in North Carolina) that where one who holds a mortgage on real estate becomes the owner of the fee, the two estates

are thus united in the same person and the former estate mergers in the latter. The equitable or lesser estate (in this case, the second mortgage) is said to be swallowed up, or "drowned out," by the legal or greater estate (fee simple). This is the doctrine of merger. Hussey v. Hill, 120 N.C. 312, 26 S.E. 919; Furniture Co. v. Potter, 188 N.C. 145, 124 S.E. 122; Waff Bros. v. Bank, 289 N.C. 198, 221 S.E. 2d 273 (1975); Webster, Real Estate Law In North Carolina §365 (1971); and 51 Am. Jur., 2d, Liens, §47.

In Tiffany On Real Property, 3d Ed. §§1480 and 1481, the doctrine of merger is analyzed as follows:

> The theory on which, upon the acquisition by one person of the mortgaged land and of the mortgage debt with the incidental lien on the land, the debt, and with it the lien, may ordinarily be regarded as extinguished, would seem to be that, under such circumstances the person owning and controlling the debt can usually have no object in keeping it alive, it being in

> substance a claim against his own property, and he may consequently be presumed to intend that the debt shall be extinguished, a presumption to which, as tending to the simplification of titles, the courts are ready to give full effect.

Under the facts of this case, at or prior to the resale of the real estate, Butner had become the sole owner and holder of the second mortgage. At the resale of the real estate, Butner purchased the real estate. Thus, under the doctrine of merger, the debt was discharged and the second mortgage lien extinguished. Therefore, Butner had no debt to prove in bankruptcy at the final meeting of creditors. Technically, the Bankruptcy Judge should not have even allowed Butner an unsecured claim.

IV.

Prior to bankruptcy, the second mortgage holders did not take any action to secure possession or commence foreclosure proceedings or secure the appointment of a receiver or sequester or take steps to sequester or attach the rents and profits in any manner. Neither did the second mortgage holders do any of these things after the conversion from the Chapter XI proceeding to straight bankruptcy.

A. The Holders Of The Second Mortgage Filed No Adversary Proceeding To Recover The Property And Obtain Relief From The Bankruptcy Stay In Order To Foreclose Their Lien Under Available State Remedies

The Bankruptcy Act as amended in 1973 provides that the Petition in Bankruptcy operates as an automatic stay against any act or proceeding to enforce a lien on the property of a bankrupt

estate. This automatic stay is provided for in Bankruptcy Rule 601. All creditors receive notice of the effect of the Petition as a stay along with notice of the first meeting of creditors. This stay remains effective during the pendency of the case unless sooner modified by the Court or the property subject to the lien otherwise passes from the control of the Court.

Any party subject to the stay may, however, obtain relief from the automatic stay and recover property from the bankrupt estate as provided for in the Rules of Bankruptcy. All such matters are governed by the Part VII Rules entitled "Adversary Proceedings." The Part VII Rules of Bankruptcy begin with Rule 701, which provides that a party may institute an Adversary Proceeding before the Bankruptcy Judge to "recover money or property" and to "obtain relief from a stay." Bankruptcy

Rule 703 provides that "[A]n adversary proceeding is commenced by filing a complaint with the court."

During the pendency of the bankruptcy proceeding, neither of the three beneficiaries of the second mortgage instituted any Adversary Proceeding before the Bankruptcy Court to recover the property and obtain relief from the stay. Had they done so, the Court would then have had to make a decision as to whether to release the property from the bankrupt estate so that the second mortgage holders could foreclose under state law. No such action and no such question was ever presented to the Bankruptcy Court for determination, even though the second mortgage holders had ample opportunities to do so.

At the first meeting of creditors on April 16, 1975, the Bankruptcy Judge directed the Trustee

to institute appropriate proceedings to sell the real estate free and clear of the second mortgage. If the second mortgage holders had wanted to, they could have immediately filed an Adversary Proceeding to recover the property for purposes of foreclosure under state law.

In June of 1975, the Trustee filed the Adversary Proceeding seeking to sell the real estate free and clear of the second mortgage. Of course, all the mortgage holders were joined as party Defendants, but Butner did not file an Answer. In fact, no creditor appeared at the hearing when the Bankruptcy Judge entered the Order for Sale on June 30, 1975. If the second mortgage holders had wanted to they could have appealed said Order within ten days from June 30, 1975, but they chose not to do so.

Also, neither of the second mortgage holders appealed the District Court's Order of Resale dated November 7, 1975, which provided for a sale of the property free and clear of the second mortgage. In fact, when the Confirmation Order of the Bankruptcy Judge was appealed to the District Court, Butner orally argued that he wanted one of two things: (a) abandonment of the real estate to the second mortgage holders or (b) allow the second mortgage holders to bid with the amount of their debt in lieu of a cash bid. At no time did any of the second mortgage holders ever orally or in writing seek to recover the property so that they could foreclose their mortgage under state law.

Therefore, Butner and the other second mortgage holders failed to comply with the substantive law of North Carolina and at no time did

they meet the requirements set forth in Gregg v. Williamson, Kistler v. Development Co., and Parker Co. v. Bank, supra. Further, Butner and the second mortgage holders failed to utilize and comply with the Rules of Bankruptcy.

CONCLUSION

The opinion of the Court of Appeals should be affirmed and this matter be remanded to the Bankruptcy Court for disposition in accordance with the Bankruptcy Final Order of July 1, 1976.

Respectfully submitted,

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CERTIFICATE OF SERVICE

Pursuant to Rule 33 of the United States Supreme Court, the undersigned hereby certifies that he has this day served three copies of this Brief on each other party separately represented by depositing the same in the United States post office in Hickory, North Carolina, with first class postage prepaid, at the following addresses:

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This the 22nd day of September, 1978.

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